CB Resource, Inc. RISK MANAGEMENT & PLANNING

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Pandemic and Related Risks Assessment Confirms Anticipated Adverse Impact to Credit Quality and Earnings – Though Community Banks are Poised to Respond

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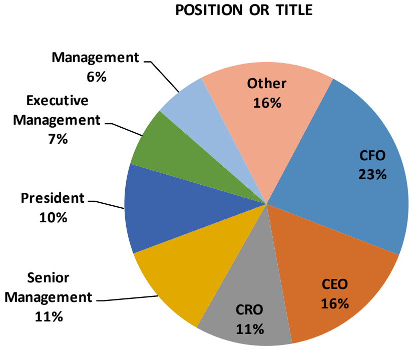
The purpose of the Pandemic and Related Risks Assessment was to provide community banks and their leaders with a tool to assess their potential risk exposure and/or levels of control in certain areas of risk. The assessment was conducted between March 23, 2020 to April 6, 2020 and was completed by senior executives (see chart for specific positions) from 121 community banks across the country.



Five risk categories were selected as assessment areas. The assessment does skew towards financial performance related risks, though it does include key operational risk considerations. The assessment consisted of a series of statements covering the following risk categories:

1. Credit Risk
2. Interest Rate Risk
3. Liquidity Risk
4. Operational Risk
5. Strategic Risk

The key risk considerations were presented as risk attribute statements. The level of risk was measured by the degree of agreement or disagreement to each statement. Participants were also provided options to express "Not Applicable" or "Don't Know". Additionally, comment sections were available for each risk statement.

The subsequent responses were plotted to indicate risk levels as Low, Low-Moderate, Moderate, Moderate-High, or High.

2020 VS 2007 AVERAGE KEY MEASURES

One additional point to consider as you review the assessment results--the last time the community bank industry was facing a crisis was 2007—the Great Recession. One outcome from that crisis was fewer banks. Today's community banks are wiser, bigger, have a stronger balance sheet, make more money, and have more capital. It is our view, and we believe the assessment data bears it out, that today's community banks are stronger and better prepared to respond to significant adversity regardless of the form it takes. Time will tell.

The following table compares some of the key performance measures between 2020 and 2007.

	Assets	ROAA	ROAE	NIM	ER	T1 Cap	NPA
2020	218,693	1.09	9.28	3.79	67.39	10.99	0.45
2007	124,002	0.95	8.85	4.07	67.00	9.76	0.48
Variance	76%	15%	5%	-7%	1%	13%	-6%

I. SUMMARY OF KEY FINDINGS

Upon review of the assessment results, two key risk consideration areas surfaced. These considerations included: 1. Low to Low-Moderate Risk Findings, and 2. Moderate to Moderate-High Risk Findings.

a. Low to Low-Moderate Level of Findings

The Low to Low-Moderate Risk Findings consist of risk areas that require clearly defined policies, procedures, and practices. The findings included credit risk identification, program design, contingency funding practices, crisis management, workplace safety, and customer service and care.

The following items are the results of the lower risk findings.

1. Credit Risk: Over 66% have developed a comprehensive watch list of "at risk" loan customers.
2. Credit Risk: Over 70% have established an accommodation program to adjust terms and/or pricing for at risk customers.
3. Liquidity Risk: Over 80% have a contingency funding plan/ position that provides for an abundance of readily available alternative funding – in good times and bad.
4. Operational Risk: Over 61% have formed a rapid response team that routinely reassess the environment and ensures priorities and processes are appropriate and optimal. An additional 26% have some form of a team in place.
5. Operational Risk: Over 89% have prioritized employee well-being and workplace safety, including fully phased in remote work conditions, limited lobby access, and controlled ingress and egress.
6. Operational Risk: Over 89% have prioritized customer service standards to ensure product and service support, social distancing, and access to decision-makers.

b. Moderate to Moderate-High Risk Findings

The Moderate to Moderate-High Risk Findings consist of risk areas that represent potential emerging risks or threats. The findings include risks associated with performance shortfalls, deteriorating credit quality, impact of increased reserve levels, Net Interest Margin Compression, short- and long-term low interest rate environments, and missing earnings targets.

The following items are the results of the higher risk findings.

1. Credit Risk: Over 60% believe COVID-19 and related factors will negatively impact the ability to achieve their targeted/ planned 2020 loan growth goal. 24% believe it will be somewhat negatively affected.

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CB RESOURCE

Finance500 INVESTMENT & BROKERAGE SERVICES

CORPORATE OFFICE
584 Wald
Irvine, CA 92618

CALL OR EMAIL CB RESOURCE
TOLL (877) 367-8236
TEL (949) 502-6860
info@cb-resource.com
www.cb-resource.com

CALL OR EMAIL FINANCE 500
TOLL (800) 477-6266
TEL (949) 253-4000
info@finance500.com
www.finance500.com

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2. Credit Risk: Over 64% believe the pandemic and related factors will adversely impact the quality of their credit portfolio. Over 25% believe it will to some degree.
3. Credit Risk: Over 60% are likely to increase loan loss provisions due to the current crisis. An additional 23% believe they will to some degree.
4. Interest Rate Risk: Over 61% believe the interest rate market shock will have an immediate severe impact on their net income.
5. Interest Rate Risk: Over 65% believe a prolonged low interest rate environment will have a severe impact on their net income.
6. Strategic Risk: 60% believe they will not achieve their targeted/planned 2020 net income goal.

II. CREDIT RISK

Credit Risk arguably represents the single greatest risk exposure community banks face due to the pandemic. A prolonged economic downturn due to COVID-19 could result in thousands of business failures and millions unemployed. The speed of economic recovery bears the greatest impact, and unfortunately, today is the most uncertain.

Based on assessment results, most community banks have quickly identified where their credit risks reside (customers, markets, industries, etc.). Additionally, with regulatory guidance in mind, the majority have developed and introduced deferral programs and other accommodations to assist at risk customers with weathering the crisis.

The assessment results also indicate that most community banks are not naïve or ill prepared to respond to the adverse financial impact of the pandemic and related risk factors. Most expect COVID-19 to adversely impact their bank's loan portfolio. Most believe it will impede their growth plans. And most believe they will be increasing their loan loss provisions with a direct negative impact to earnings.

What is less clear is the longer-term outlook. Are there strategic alternatives to offset or mitigate the loss of growth and earnings? One third believe they have figured it out. For the majority, the level of uncertainty and unknowns are high and it is too soon to fully course correct.

Credit Risk	Strongly AG	Agree (AG)	Somewhat AG/DIS	Disagree (DIS)	Strongly DIS	NA or DK	Rating	Score
COVID-19 and related factors will not negatively impact our ability to achieve our targeted/planned 2020 loan								
All	3.70%	9.88%	24.69%	40.74%	19.75%	1.23%	Moderate-High	3.64
The pandemic and related factors will not have an adverse impact on the quality of our credit portfolio.								
All	3.70%	4.94%	25.93%	35.80%	28.40%	1.23%	Moderate-High	3.81
The oil price war will not have an adverse impact on the quality of our credit portfolio.								
All	14.81%	48.15%	19.75%	8.64%	0.00%	8.64%	Low-Moderate	2.24
We have developed a comprehensive watch list of loan customers by industry type.								
All	17.28%	49.38%	20.99%	7.41%	1.23%	3.70%	Low-Moderate	2.23
We have established an accommodation program to adjust terms and/or pricing for at risk customers.								
All	23.46%	46.91%	16.05%	8.64%	0.00%	4.94%	Low-Moderate	2.10
We are not likely to increase loan loss provisions due to current crisis.								
All	0.00%	9.88%	23.46%	44.44%	16.05%	6.17%	Moderate-High	3.71
We have identified and are pursuing alternative loan growth opportunities that will serve to mitigate the adverse impact of the current market conditions.								
All	3.70%	27.16%	20.99%	35.80%	3.70%	8.64%	Moderate	3.09

COMMENTS REGARDING CREDIT RISK

Here are a series of comments related to key elements of the risk assessment:

Comments associated with "growth":

1. We may have a larger demand due to reducing cashflows and opportunities coming from larger banks to deal with people they know and trust in their community.
2. We were on track for surpassing our expected loan growth for 2020. However, this crisis is deeply impacting a high percentage of customers and their ability to consider the purchase of a new home or property. It may well impact many customer's ability to repay their current loan or meet other obligations for a period of time.
3. We may have a significant increase in past dues that will require extensions or deferments.
4. At this point, the focus will be with managing the current loan portfolio and needed loan modifications rather than originating new loans.
5. Already losing productivity with staff working remotely. We expect that loan modifications will have a negative impact. Expect to see real estate related deposit run-off over the next several months.

Comments associated with "portfolio quality":

1. We are already seeing requests for deferrals for our own portfolio, as well as the Fannie Mae portfolio that we service.
2. This will cause stress for borrowers and some will probably be forced to liquidate assets because of the inability to repay.
3. We have exposure to the hotel/motel and restaurant industries that are currently under pressure. Other customers with investment rental properties may also see higher rates of delinquency, affecting cash flow.
4. If CRE borrowers do not receive lease payments from tenants, then it is expected that loan payments will be adversely impacted. The length of the time period is hard to assess.
5. Many small businesses are going to have to take on additional debt to survive and this will impact future cash flows.
6. Even if there is no direct impact on the quality of the loan, the underlying businesses supporting the cash flow will be weakened. Strong guarantors will see erosion in their financial strength as they provide credit support.
7. We anticipate short-term disruptions in customers being able to make their home mortgage payments. Our local economy is generally strong, but some workers will still be laid off or have hours reduced.

Comments associated with "at risk customers, sectors, industries":

1. We completed our first pass at this, but management recognizes the more we learn, the more time passes, the more comprehensive our review needs to be.
2. The Bank's loan portfolio will be segmented into various categories to facilitate monitoring.
3. Portfolio review and monitoring has been enhanced in response to the current situation.

Comments associated with "program modifications or accommodations":

1. We are already working on deferral programs and assume there will be more requests in the future. The SBA programs proposed will likely be widely utilized.
2. We were champions for the FFIEC to give guidance about TDRs and we are aggressively using their Guidance to defer payments.

Comments associated with "ALLL and loan loss provision":

1. We will increase provisions as necessary to meet the projections over the year as they change.
2. We have already increased our ALLL as a proactive measure. We will also re-evaluate the ALLL at quarter end.
3. We have doubled our LLP.

Comments associated with "strategic alternatives":

1. Such alternative loan growth opportunities may not be clearly available dependent on the overall impact of the economic fallout caused by this issue. Any such opportunities remain to be seen, especially for small institutions.
2. The Bank is focused on serving our customer base. The Bank is always looking for growth opportunities, but it is not the primary focus at this time.
3. Some banks will not handle this crisis well and it will open opportunities for us.
4. We plan to continue our existing growth strategy.

III. INTEREST RATE RISK

Interest Rate Risk was already presenting a challenge prior to the pandemic impact. Within the previous 12 – 18 months the industry was navigating a rising interest rate environment only to be hurled back into a declining to low interest rate environment.

Based on assessment results, one of the most powerful mitigants to the low interest rate swing has been loans with embedded floors or pre-payment penalties. Most community banks are asset sensitive and may not be open to SWAP strategies or other investment alternatives.

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For most, both the near term and the potential prolonged low interest rate environment will have a severe impact on net income.

For those that have been successful or partially successful at building a stable, low cost relationship-based deposit portfolio (30% and 35% respectively), they believe there will be some relief from the imminent margin compression.

Interest Rate Risk	Strongly AG	Agree (AG)	Somewhat AG/DIS	Disagree (DIS)	Strongly DIS	NA or DK	Rating	Score
The interest rate market shock will not have an immediate severe impact on our net income.								
All	2.74%	13.70%	17.81%	45.21%	16.44%	4.11%	Moderate-High	3.61
A prolonged low interest rate environment will not have a severe impact on our net income.								
All	2.74%	10.96%	16.44%	39.73%	26.03%	4.11%	Moderate-High	3.79
Our low-cost, relationship-based deposits significantly diminishes the adverse impact of the interest rate shock.								
All	10.96%	20.55%	35.62%	23.29%	4.11%	5.48%	Moderate	2.88
Our interest rate SWAPs have effectively mitigated our interest rate risk up or down.								
All	1.37%	4.11%	13.70%	5.48%	2.74%	72.60%	Moderate	3.15
Our bond portfolio will reduce the adverse impact of the current interest rate shock.								
All	1.37%	20.55%	30.14%	23.29%	4.11%	20.55%	Moderate	3.10
Our embedded floors and/or prepay penalties in our loans will reduce adverse impact to our loan portfolio								
All	2.74%	42.47%	30.14%	9.59%	4.11%	10.96%	Moderate	2.66

COMMENTS REGARDING INTEREST RATE RISK

Here are a series of comments related to key elements of the risk assessment:

Comments associated with "immediate adverse impact":

1. We are positioned fairly well for earnings over the next 2 quarters but beyond that, loan demand will be critical.
2. This will clearly affect all institutions interest income negatively.

Comments associated with "longer term impact":

1. As a bank with moderate asset sensitivity, low interest rates negatively impact NIM.
2. While have only recently emerged from a prolonged low rate environment, we know what it takes to grow income over the long term.

Comments associated with "funding costs":

1. Rates have been so low on deposits, there is not much room to come down compared to the larger change in rates.
2. Our Funding costs have been half compared to our peers in recent years. They will be able to move their rates closer to our funding costs. We do have room to decrease rates somewhat and believe this will help us mitigate the decline in Loan Yields. However, it will have some adverse impact.

IV. LIQUIDITY RISK

Liquidity Risk appears to be the least impacted of the financial performance related risk categories which is perhaps not surprising. Banks at $5B or less in assets finished 2020 with a median Liquidity Ratio of 21.9% The average community bank is very liquid, facing the prospects of slower growth. One could surmise that funding needs are not likely to increase during 2020. Over 60% of the assessment respondents agree or somewhat agree that the pandemic will not result in an adverse impact to liquidity. An overwhelming majority believe that their contingency funding position is more than adequate to address any liquidity requirement their bank may face.

With that said, over 30% believe and 24% somewhat believe that commercial and retail customer cash flow needs may adversely impact their liquidity position.

Liquidity Risk	Strongly AG	Agree (AG)	Somewhat AG/DIS	Disagree (DIS)	Strongly DIS	NA or DK	Rating	Score
Our contingency funding plan/position provides for an abundance of readily available alternative funding – in good times and bad.								
All	32.88%	47.95%	13.70%	4.11%	0.00%	1.37%	Low-Moderate	1.89
Cash flow needs of our commercial and/or retail customers will not have an adverse impact on our liquidity								
All	5.48%	30.14%	24.66%	27.40%	5.48%	6.85%	Moderate	2.97
The current market conditions do not result in an adverse impact to our liquidity.								
All	5.48%	26.03%	39.73%	21.92%	4.11%	2.74%	Moderate	2.93

COMMENTS REGARDING LIQUIDITY RISK

Here are a series of comments related to key elements of the risk assessment:

Comments associated with "customer cash flow needs":

1. We have seen an increase in our liquidity but think that is temporary in nature. We feel that there will be an adverse impact that will impact our liquidity position to some degree.
2. Although we have sufficient liquidity, the cash flow needs of customers will likely increase greatly due to loss of revenues.

Comments associated with "market conditions adversely impacting liquidity":

1. We have seen an uptick in liquidity in the short run as people go from securities to cash. However, we think this could be a phenomenon enjoyed more in the short run than the long run if conditions persist as they are.
2. We are concerned that borrowing capacity with FHLB may be reduced.
3. We believe, as in the great recession, we could see an increase in deposits as a flight to safety. We have seen that over the last week.

V. OPERATIONAL RISK

The Operational Risk Assessment limited its scope to business continuity, managed crisis response process, employee safety and well-being, and customer service and care. These responses illustrate that most community banks maintain sound policies, procedures, and processes. Most banks are prepared to respond to crisis in a disciplined and orderly fashion which can be attributed to regulatory requirements.

When assessing rapid response, readiness, and sound practices, over 61% have effective rapid response teams in place and are effectively managing operating priorities. When it comes to workplace safety, employee well-being, customer service standards, and customer care, over 89% believe their policies, process and procedures are effective.

A clear majority of banks believe that their business continuity plan clearly established a course of action to effectively respond to COVID-19.

Operational Risk	Strongly AG	Agree (AG)	Somewhat AG/DIS	Disagree (DIS)	Strongly DIS	NA or DK	Rating	Score
Our business continuity plan established a clear course of action to respond to COVID-19 conditions.								
All	9.59%	42.47%	27.40%	16.44%	1.37%	2.74%	Moderate	2.56
We have formed a rapid response team that routinely reassess the environment and ensures our priorities and processes are appropriate and optimal.								
All	24.66%	36.99%	26.03%	8.22%	0.00%	4.11%	Low-Moderate	2.19
We have prioritized employee well-being and work place safety, including fully-phased in remote work conditions, limited lobby access, and controlled ingress and egress.								
All	54.79%	34.25%	6.85%	2.74%	0.00%	1.37%	Low-Moderate	1.57
We have prioritized customer service standards to ensure product and service support, social distancing, and access to decision-makers.								
All	41.10%	47.95%	6.85%	2.74%	0.00%	1.37%	Low-Moderate	1.71

COMMENTS REGARDING OPERATIONAL RISK

Here are a series of comments related to key elements of the risk assessment:

Comments associated with "their Business Continuity Plan":

1. Our bank continuity plan provided a great base and we have made adjustments as needed.
2. The bank's pandemic plan establishes a clear course of action, but there are challenges specific to COVID-19.
3. It addresses pandemic response, but every crisis is different, so we still have had to make decision or address issues we hadn't considered.

Comments associated with "rapid response teams":

1. Our Enterprise Risk Management team and subset in constant communication

Comments associated with "employee safety and well-being":

1. We went to a high level of remote access in just a couple of days and have had very little disruption in our business.

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VI. STRATEGIC RISK

The Strategic Risk Assessment scope included growth impact, earnings impact, capital impact, and strategic alternatives. Very few banks believe that there will not be some level of adverse impact to their strategy and earnings. Less than 15% believe they will achieve their 2020 growth goal. 9% believe they will achieve their 2020 net income target. In short, 6 out of 10 banks expect a shortfall in targeted net income due to COVID-19 and related risk factors.

From a favorable perspective, over 60% agree or somewhat that their capital levels will not be adversely impacted. One additional favorable finding, 42% agree or somewhat agree that they have identified new growth or income opportunities to mitigate the negative impact of the current market conditions.

Strategic Risk	Strongly AG	Agree (AG)	Somewhat AG/DIS	Disagree (DIS)	Strongly DIS	NA or DK	Rating	Score
We will achieve our targeted/planned 2020 asset growth goal.								
All	0.00%	13.85%	36.92%	30.77%	7.69%	10.77%	Moderate	3.36
We will achieve our targeted/planned 2020 net income goal.								
All	1.54%	7.69%	24.62%	36.92%	23.08%	6.15%	Moderate-High	3.77
Our non-interest income will not be adversely impacted due to current market conditions.								
All	3.08%	21.54%	26.15%	43.08%	3.08%	3.08%	Moderate	3.22
Our M&A goals will not be adversely impacted by current market conditions.								
All	0.00%	7.69%	16.92%	15.38%	10.77%	49.23%	Moderate-High	3.58
Our capital levels will not be adversely impacted by current market conditions.								
All	7.69%	38.46%	24.62%	27.69%	0.00%	1.54%	Moderate	2.73
We have identified new growth or income opportunities that will effectively mitigate the current adverse market								
All	0.00%	13.85%	29.23%	47.69%	4.62%	4.62%	Moderate	3.45

COMMENTS REGARDING STRATEGIC RISK

Here are a series of comments related to key elements of the risk assessment:

Comments associated with "growth plans":

1. While core loan growth may come down, we expect to supplement with SBA PPP loans.
2. We do not see a reason at this time to change our plan.
3. We have a strategic plan that targets an acquisition in 2021. We could still meet this goal, but a lot will depend on the bank's performance in 2020, the capital position by year end, and projections for 2021.

Comments associated with "income goals":

1. I believe we will achieve our loan targets. However, we probably will not be able to offset margin compression resulting from the 150-basis point reduction by the Fed.
2. We cannot offset the reduction in loan rates with a reduction in deposit rates. We are not interested in a workforce reduction. We will make other cost savings decisions along the way, but they cannot offset such a big drop in interest income.
3. Our net income goals are a stretch. We do not project to meet that goal based on the margin compression, the possibility of loan loss, or asset quality deterioration.

Comments associated with "capital":

1. We have a very healthy reserve. However, we will probably add to it because we are conservative in nature. So, our pure capital may not grow as fast but our capital + ALLL will be the same or higher.

Comments associated with "new opportunities":

1. While we are partially mitigating some of the issues, we feel that the impact cannot be fully offset by some of our new opportunities.

CLOSING THOUGHTS AND OBSERVATIONS

The data confirms that today's community banks are mature and prepared to address adversity and crisis. Though this assessment was completed within the early and uncertain stages of the pandemic, it appears that most community banks were proactive and deliberate in their response to mitigate risk associated with the crisis. The comparative analysis highlighted in the opening section of this report illustrates the community bank industry is stronger than the community banks that were thrown into the Great Recession.

When it comes to policies, procedures and practices, it is clear that the majority of community banks are well positioned to manage their businesses through this uncertain environment. The higher risk areas identified, illustrates that community banks are aware of where the risks reside, and believe they have the capabilities to manage through the adversity.

If there was one area that leaves some question as to what the other end of the crisis will look like, is that most banks have not necessarily identified strategic alternatives to fully neutralize the adverse impact to credit quality and earnings.

On a closing note, since this assessment was conducted, the community bank industry has demonstrated their value and leadership in implementing the Paycheck Protection Program. I believe many will argue that community banks were the hero in getting the dearly needed funds in the hands of existing and new small business customers. All completed with less manpower, technology, and other resources than their much larger bank counterparts.

Complementary access to assessment can be found by following this link. Questions about CB Resource's services or this assessment can be directed to Robert Finch at 949-502-6910 or rfinch@cb-resource.com.